# A REPORT ON SOME PREVAILING LEGAL AND ACCOUNTING PROCEDURES INVOLVED IN PARTNERSHIPS

A REPORT

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# CHAPTER I

## INTRODUCTION

One of the limitations of the single proprietorship is the fact that only one person has the incentives that come from a personal interest. Every worker of the single proprietorship is a hired employee. Therefore, it may be difficult to keep aggressive employees and secure their best efforts in this capacity. Every worker at some time has a personal ambition to be his own boss, to be consulted and to have some authority concerning the tasks he is performing.

The previous statement may express the primary reasons why the partnership association came into existence. The partnership association permits as many persons as desired to pool their assets and to take part in promoting some common cause.

During the Middle Ages, a group of merchants sometimes combined their assets and chartered a vessel, each bringing to the vessel his own stock of goods which each merchant traveled with to various distant foreign lands. Here the merchants sold their goods to the best advantage, each merchant selling his goods independently of the others, except, as Dutton states, "for the common participation in the use of the vessel."[1] This was an early form of the partnership which was called a joint venture.

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[1] H. P. Dutton, Business Organizations and Management (New York: A. W. Shaw Company, 1927), p. 73.

Today the partnership is classed as a general or special association of two or more people, and engages in trading or nontrading activities. A general partnership exists when the partners operate a particular kind of business for the purpose of buying and selling of goods and services. A special partnership is created to perform a specific task, such as conducting a mining operation, after which, the partnership is terminated. A trading partnership exists when partners engage in buying and selling of goods, where the nontrading partnership exists when the partners perform tasks other than those of buying and selling of goods, such as performing services such as those performed by lawyers, doctors, and accountants. This report is primarily concerned with the general partnership.

Partners may be classed as general, nominal, silent, secret or dormant. A general partner engages in the conduct of the business and is publicly known. The nominal partner merely implies that he is a partner, but does not share profits nor management. The silent partner takes no part in the activities of the business but may be known to the public. The secret partner is not known to the public, but engages in partnership activities. The dormant partner takes no part in the business activities and is not publicly known.

This report concerns itself with a study of prevailing legal and accounting principles involved in an association of two or more persons operating as co-owners of a business for profit. Although the partnership association has existed for many centuries, frequently the partners do not conduct their business activities in accordance with prevailing principles of law and accounting. The principles presented in this report should be considered long and honestly before the partnership is created.

This report highlights some prevailing accounting and legal procedures involved in the partnership at the time of initial investments of the partners; at the time of operating profits and losses distribution; and distribution of assets upon dissolution and liquidation. The report also presents some prevailing rights, duties and limitations of each and all the partners. Some cases will be presented to illustrate the legal procedures imposed on the partners in relation to each other and to third persons.

The study is supported by library literature, text books of law and accounting, court cases, statutory enactments, and professional journals relating to the subject. The report consists of five chapters. The first is an introduction, followed by chapters covering some technical aspects of partnership creation, operation, and dissolution, respectively. The final chapter will include the summary which will present the writer's personal views on prevailing legal and accounting procedures involved in the partnership.

This report shall be a ready source of some important legal and accounting principles involved in a partnership, and shall be accessible to any students of law or business desiring such information as contained herein.

## CHAPTER II

## CREATION OF THE PARTNERSHIP

One of the consequences of a partnership relation is the mutual agency relationship existing among the partners. That is, each partner is an agent of the partnership, and therefore a principal too. It has been said that the real basis of individual unlimited liability is the fact that partners have the status of principal in all partnership transactions.

A person who is not actually a partner may by his actions and conduct, lead others to believe that he is actually a partner in an existing firm of persons who are actually associated as partners. According to the doctrine of estoppel which prevents a person from "pursuing a certain course of action or of disputing the truth of certain matters when such would be unjust,"[1] a partnership liability will be imposed upon such a person in favor of those who have extended credit to the partnership. That is, a person may be liable where he has knowledge of the fact that another is holding him out as a partner, unless he takes some steps in preventing such representation.

### Statutory Requirements

Like the single proprietorship, the legal requirements for the

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[1] Ronald A. Anderson, Business Law (Cincinnati: South-Western Publishing Company, 1963), p. 976.

creation of a partnership are very simple. A business partnership can be created and operated without any written agreement or contract. But because all partners have an equal right to share in profits, management, and ownership, the typical partnership is vulnerable to more legal complications than the typical single proprietorship. However, there is no limitation on the number of partners that may be associated together.

Like all businesses, the partnership must be created for legal purposes. It cannot be created - legally - to perform immoral and illegal acts, or acts that are contrary to public policy. Illegal activities cause partners to forfeit their rights to sue on contracts involved in the illegal act.

As stated earlier, a contract need not be in writing. But according to Ronald A. Anderson, "a partnership agreement must be in writing, however, if it is within the provision of the Statute of Frauds that a contract which cannot be performed within one year must be in writing."[1] That is, if two or more partners agree to create a partnership today that shall continue for more than one year or to create a partnership two years from this date, such agreement must be in writing to be valid under all circumstances. However, the duration of the partnership may not be stated, or even known. In such a case, a written contract is not required under the statutes because such a partnership could be terminated within, say, two months.

Statutes do not always require the partnership to have a firm name, although it is customary to have one. The name may be real or

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[1] Ibid., p. 646.

fictitious, or there may be more than one name, such as in the case of branch houses. But there are certain limitations regarding the selection of a firm name. According to the statute as expressed by R. A. Anderson, "the name cannot be the same as or deceptively similar to the name of another firm for the purpose of attracting its patrons (or customers)."[1] Many states require that all partnerships with fictitious names be registered with some specified public official.

## Partnership Agreement

Statutes do not require that the partnership agreement take any particular form. In fact, it may be based merely on a meeting of the minds and a mutual understanding between the partners. However, the best procedure is to execute a written agreement even though the writing may not be required. A written agreement which clearly states the rights and duties of the partners will help prevent future frictions and misunderstandings among the partners.

The partnership agreement is generally called the articles of partnership. The information or contents of the agreement vary according to the nature of the partnership and the desires of the partners. But in any case the agreement need to cover all major points of the partners conduct. Such agreement may include: the names of partners; the name of the partnership; the duration of the partnership; the nature of the business; the capital contributions of the partners; methods of sharing profit and loss; definitions of authority and duties of partners;

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[1] *Ibid.*, p. 644.

causes and methods of dissolution; and methods of distribution of assets upon liquidation.

The contents of the partnership agreement may be changed at any time. Changes relating to business practices which are not fundamental to the partnership may even be made by a majority of the partners. "Any provision of the partnership agreement may be waived by any partner, and habitual assent to a violation of a provision in the partnership agreement may be deemed to be a waiver thereof."[1] However, in order to reduce or even avoid future disputes and misunderstanding, these "habitual assents" and "waivers" should be put into writing. That is, if the agreement is to undergo substantial changes, it is best to have an entirely new agreement drawn up.

## Accounting for Partners' Investments

The accounting problems of the partnership are basically the same as those in any other business organization. The procedures employed in the accounting for assets and current material and services costs are not changed because of the type of ownership. Neither are the methods for recording income and liability changed. But as Paton puts it, "the special features of the partnership accounting relate primarily to recording and tracing of capital, the treatment of personal services furnished by the partners, the division of profits and the adjustments of equities required upon the occasion of reorganization

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[1]Stanley M. Brown, Business Executives' Handbook (New York: Prentice-Hall, 1939), p. 916.

or liquidation of the firm."[1]

To illustrate some prevailing accounting procedures for recording financial transactions of partners, it is assumed in Chapters II through IV that John Able, Robert Ball, and Jack Cole operate as co-owners a business for profit. At the time of creation there were only two partners, Able and Ball. Six months after creation, Cole was admitted to the partnership. The firm operated under the name of Able-Ball Distributing Company, the fiscal accounting period being based on the calendar year.

It is assumed that on January 1, 1963, Able and Ball created as co-owners the Able-Ball Distributing Company. It was agreed that Able and Ball would make initial capital investments of $50,000 and $40,000 respectively, and that profits and losses would be shared in the ratio of partners' capital. The entry to record the initial investment is:

| | | |
|---|---|---|
| Cash | $90,000 | |
| Able, Capital | | $50,000 |
| Ball, Capital | | 40,000 |

The investments of partners may be in any asset form as long as it is in keeping with the will of the partners. However, assets other than cash are valued according to the will of all partners, and "the values originally assigned to assets are credited to the partner investing the assets, and become a measurement of his interest; and (any) subsequent changes in these values that are reported on the books or that emerge from disposal of properties are recognized as profit and loss items that are divided in the agreed manner among all the partners."[2]

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[1] W. A. Paton, Accountants' Handbook (New York: Ronald Press Company, 1949), p. 1241.

[2] Hary Simons, Advanced Accounting (Cincinnati: South-Western Publishing Company, 1961), p. 7.

When a partnership has been very successful, the old partners may admit a new partner with the agreement that part of the new partner's investment shall be allowed as a bonus to the old partners, or that firm goodwill should be created and distributed among the old partners. However, a partnership may need the services and assets of some third person in order to survive. In such case a new partner may be admitted with the agreement that part of the capital of the old partners will be transferred to the new partner's capital account, such being considered as a bonus to the new partner, or firm goodwill may be created and credited to the new partner's capital account.

To illustrate the accounting for bonuses and goodwill, continuing the previous example, it is assumed that on June 25, 1963, the firm had been very successful and had a net worth of $120,000. Cole offered to contribute $50,000 worth of equipment into the firm as requirement for becoming a new partner with a 25% interest in the firm assets. The offer was accepted. Entries will be made to illustrate the investment of Cole assuming that the old partners received a bonus, and assuming that goodwill is created and credited to the old partners' capital account.

BONUS METHOD. Cole's $50,000 investment will increase total assets to $170,000, but $42,500 will give him a 25% interest in the firm assets and profits. The amount by which equipment exceeds the interest received is considered as a bonus to the old partners. Able and Ball distribute the bonus in the ratio of 55% and 45% respectively. The entry to record Cole's investment is:

| | | |
|---|---|---|
| Equipment | $50,000 | |
| Able, Capital | | $ 4,125 |
| Ball, Capital | | 3,375 |
| Cole, Capital | | 42,500 |

GOODWILL METHOD. If Cole's investment of $50,000 is to represent 25% of total net worth, total net worth would have to be $200,000, and the combined capitals of Able and Ball would be $150,000. But since their combined capitals equal only $120,000, the excess of $30,000 represents goodwill to be distributed to the old partners' capital accounts as follows:

| | | |
|---|---|---|
| Equipment | $50,000 | |
| Goodwill | 30,000 | |
| Able, Capital | | $16,500 |
| Ball, Capital | | 13,500 |
| Cole, Capital | | 50,000 |

To illustrate a reduction in the old partners' capital account, it is assumed that on June 25, 1963, the firm needed additional equipment but was short on working capital; it also needed the skills possessed by Cole. Current net worth amounted to $90,000, same as original investment. Cole offered to contribute $40,000 into the firm for a 33.33% interest in the firm. The offer was accepted.

Entries will be illustrated assuming a bonus to Cole, and assuming the creation of goodwill.

BONUS METHOD. The net assets after Cole's contribution amounted to $130,000. Therefore, $43,333 will give him a one third interest in the firm. The excess of Cole's capital over investment is considered to be a bonus to be deducted from the old partners' capital account and added to cole's capital account as follows:

| | | |
|---|---|---|
| Cash | $40,000.00 | |
| Able, Capital | 1,833.15 | |
| Ball, Capital | 1,499.85 | |
| Cole, Capital | | $43,333 |

GOODWILL METHOD. If the combined capitals of Able and Ball represent 66.67% of total capital, total capital equals $135,000 or 100%

and Cole's 33.33% interest will equal $45,000. The excess of Cole's capital over investment represents goodwill to be distributed as follows:

| | | |
|---|---|---|
| Cash | $40,000 | |
| Goodwill | 5,000 | |
| Cole, Capital | | $45,000 |

A partner can at any time sell part or all of his interest in a firm to a third person. If the remaining partners accept the third person as a partner, the old partnership is terminated and a new one created. However, the remaining partners have the right to reject the third person as a partner. In such case the third person "simply acquires, in accordance with his contract, the profits, and upon dissolution, the interest, to which the original partner would otherwise have been entitled."[1] Such third person receives no right to manage and control the partnership.

When an individual acquires a portion or all of the interest of a partner in business, the interest acquired is recorded to the capital of the new partner and the capital of the selling or old partner is correspondingly reduced. The amount paid for the interest is not recorded on the books of the partnership, but simply represents a transaction between two individuals acting in their private capacities. After the investment of the new partner, profit and loss sharing ratios will have to be adjusted according to the new or modified agreement.

[1]William H. Schrampfer, Law In Its Application to Business (New York: Rinehart and Company, 1949), p. 745.

# CHAPTER III

## OPERATIONS OF THE PARTNERSHIP

### Rights and Authorities of Partners

Each partner has an individual ownership in firm property. One partner's rights in partnership property is not assignable, except when the rights of all partners are assigned in the same property. Partners have an equal voice in the management and control of the partnership unless they have agreed otherwise. The partnership agreement usually provides that management be shared equally and that all business concerning the partnership shall be subject to mutual consultation and agreement.

All partners have a right to any information relating to the conduct or activities of the partnership. The right to information is essential to a proper exercise of the right to manage and control the firm. That is, if a partner is to manage a business properly and efficiently, he must have access to all important information concerning the business. The right to information also includes the right to inspect the books of the partnership, as well as a right to an accounting.

Each partner has a right to reimbursement of capital contribution to the firm, advances beyond capital contributions with interest, and for payments made and personal liabilities incurred by him in the ordinary conduct of the partnership business.

As stated earlier, the partners have an individual ownership in firm property. Therefore, just as the individual proprietor has specific legal rights to his property, the property, the partners have basically those same rights to their property - collectively though. To highlight some rights which the statutes guarantee each partner in relation to each other, the following case is presented.

SHRADER vs. DOWNING
Supreme Court of Washington, 1914

> Shrader and Downing were partners in the real estate and insurance business. Downing purchased a tract of land which he plotted into lots and blocks. Downing caused the streets to be built on the property and placed it in the hands of the partnership to be sold, at prices fixed by himself, on a ten per cent commission. All costs were advanced by Downing.
>
> The adventure proved profitable. Shrader claimed an interest in the profits, contending that the purchase was made on behalf of the partnership. Downing refused to pay. On the trial, the court ruled in favor of Downing. Shrader appeals.[1]

Judge Fullerton delivered the opinion of the court. And according to him a partner must act in the utmost good faith toward his copartner, and that if he purchases property for himself when the firm was entitled to such purchase - and can make such purchase, or enter a contract for himself when it was his duty to obtain such for the firm, he will be treated as a trustee of the partnership with reference to such actions. But a partner is not prohibited from engaging in businesses outside of the partnership. As Judge Fullerton puts it, "he may buy and sell real estate or any other property with his individual means, without becoming liable to the partnership, if the transaction

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[1] Paul P. Ashley, Cases on Business Law (New York: Prentice-Hall, Inc., 1929), p. 852.

is disconnected from the partnership business, is not conducted in competition or rivalry therewith, and he is under no duty to conduct the transaction on behalf of the partnership."[1]

In the case above the partnership had no available means of purchasing the property. Downing's purchase deprived the partnership of nothing. Instead, his purchase produced a ten per cent commission for the partnership, all that the firm would have received if any other outsider had purchased the land. Shrader received his share of the commissions without ever offering to let such go to Downing as a reimbursement for the advances made on the property. In fact, he made no claim until after the profits had been made. Judge Fullerton stated that "it would seem that if what he now claims was his original understanding he would not have let his partner take the entire burden and risks of the adventure."[2] Therefore Downing had a right to engage in the adventure through his individual means. The judgement in favor of Downing was affirmed.

AUTHORITY. As for authority, all partners have the right to act as agent for the partnership. As an agent, a partner has the authority to bind the partnership in all transactions which are within the ordinary conduct of the business. Although partners have the right to act as agent of the partnership, specific powers and authority may be expressed in the partnership agreement. That is, the agreement may provide for the division of authority between all partners, such authority possessed by any partner depending on the nature of the

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[1]*Ibid.*, p. 853.

[2]Ibid., p. 853

partnership business and the desires of the partners.

## Duties and Liabilities

It may be said that a partner's duties include the tasks of assuring the rights of his copartners. However, specific duties of each partner may be expressed in the articles of partnership. The partners' duties other than assuring the rights of his copartners generally depend on the nature of the partnership business and the desires of the partners. But to further illustrate and highlight some important duties imposed on each partner, the following case is presented.

MURPHY vs. CRAFTS
Supreme Court of Louisiana, 1858

> Murphy and Crafts were partners in a general commission business under the name of Murphy & Crafts. Their contract of partnership was in writing and the third article stated that neither partner shall indorse any note, draft, or give their signatures separately or collectively, except for their own ordinary purpose. Crafts accepted in the partnership name, for his brother-in-law, bills of exchange to the amount of $12,500. His brother-in-law failed in business, and the partnership loss, as a result of the acceptance of bills, the sum of $5,592.90. The lower court ruled in favor of Murphy.[1]

Judge Story delivered the opinion of the court. According to Judge Story, "one of the most obvious duties and obligations of all partners is to conform themselves to all the stipulations in the partnership articles."[2] Therefore any deviation in the performance of such duties and obligations which produce loss or injury to the partnership are to that extent borne by the partner who causes the loss or enjury,

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[1] *Ibid.*, p. 856.

[2] *Ibid.*, p. 857.

and he is obligated to indemnify the other partners for such loss or injury.

In the case above, Crafts is clearly bound and obligated to indemnify the plaintiff, Murphy, for the loss resulting from his failure to perform his duties in accordance with the articles of partnership. Judge Story affirmed the judgment of the lower court.

LIABILITIES. The common law provides that all partners are equally liable upon partnership contracts. And Section 15 of the Uniform Partnership Act provides that all partners are liable jointly and severally for all debts of the partnership.

In the absence of statutory provisions, suits upon a partnership liability must be brought against all partners collectively. No one partner can be sued alone unless he assumes a personal liability for the debts of the partnership. Since a joint obligation is base upon one right, a release of one partner extinguishes the right and therefore releases all other partners too. However, one partner may be released without effecting a release of the other partners if the release specifically reserves the right against the other partners.

According to statutes, in the event of death of one partner, the existing obligation survives not only to the remaining partners, but the estate of the deceased partner is not liable also. All partners are liable for torts and fraud committed by any partner during the ordinary conduct of the business. The injured party may sue all the partners, or may sue any one of the partners.

According to Section 17 of the Uniform Partnership Act, "a person admitted as a partner into an existing partnership is liable for all the obligations of the partnership arising before his admission as though he had been a partner when such obligations were incurred, except that this liability shall be satisfied only out of partnership property."[1]

To illustrate the nature of some partnership liabilities the following case is presented.

BOARDMAN & GRAY vs. ADAMS & HACKLEY
Supreme Court of Iowa, 1857

> Boardman & Gray, manufacturers of pianos, sue to recover the price of four pianos delivered to Adams & Hackley. Adams contended that the firm was not a general partnership, but a partnership in the newspaper and printing business only, and that the pianos were sent to Hackley only.
>
> However, Adam wrote the plaintiffs: "Your advertisement of pianos is in our paper, and your offer to us of an agency, we accept. But ... it will be necessary to have a piano here...Being a musician myself, and a member of the Philharmonic Society... I am pretty confident that something can be done." Also Hackley wrote the plaintiffs: "I think you would promote your business by shipping to us a small, but select assortment of your instruments." There were further correspondences between the plaintiffs and the defendants, Adams and Hackley."[2]

Judge Stockton delivered the ruling opinion of the Court.

It is true that one partner cannot bind another partner on contracts created out of the ordinary conduct of the business. However, in the case above, the letters of Adams and Hackley were evidently written in the name of the partnership. After the partnership made the purchase of pianos a part of the ordinary business, any contract entered into by one partner binds the partnership--in reference to the piano purchases. In the words of Judge Stockton, "where a partnership firm,

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[1]Uniform Partnership Act, Section 17, 1914.

[2]*Ibid.*, p. 865.

embarked in a particular business, to which their engagements are confined, and to which alone their partnership contracts extend, by mutual agreement, enlarge the sphere of their operations, and include another branch of business, the power of each partner to bind the firm by his contract is co-extensive with the whole business of the partnership; and the acts of each member are as binding on the firm, in the new branch of business in which they are engaged, as they are in the former regular and ordinary business."[1] That is, if Adams and Hackley agree to add the business of buying and selling pianos to their ordinary business, the acts of each partner of the firm are binding on the other, in connection with the buying and selling of pianos as well as the printing business. Each partner is presumed to consent to all acts of his copartner, as long as such acts are within the scope of the business.

In the case just presented, Judge Stockton affirmed the judgment of the lower court.

## Accounting for Partnership Profits

In the absence of specific provisions in the partnership agreement, depreciation, depletion, and any gains or losses on the sale of assets contributed to the partnership by a partner are to be shared as though the assets had been purchased by the partnership from a third person. However, the partnership agreement may provide that such gains and losses resulting from contributed assets may be shared in such a way as to take into account any variation in the value of assets at the

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[1]*Ibid.*, p. 867.

time they were contributed from the value, say, at the time of sale. For example, it may be agreed that the portion of the gain or loss equal to the difference between the asset value at contribution and the asset value at the date of sale shall be given entirely to the contributing partner.

Methods of determining net profits and losses of partnerships are basically the same as those for any other business concern. However, the method for distributing such profits does differ. Profits and losses are divided among the partners according to the partnership agreement. That is, "when properties invested by the partners represent the particularly significant contribution to the success of the firm, partners may agree to divide profits in the ratio of the capital of the respective partners. The agreement shall indicate specifically whether the ratio is to be defined in terms of (1) capitals upon formation of the partnership, (2) capitals at the end of each fiscal period, (3) capitals at the beginning of each fiscal period, or (4) average capitals for the period."[1]

To illustrate the average capital for the period, the assumptions pertaining to the Able-Ball Distributing Company are continued. It is now assumed that the firm has operated for a period of two years. The partners agreed that profits and losses would be shared in terms of average capital for each fiscal period. A summary trial balance and income statement is presented below.

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[1]Harry Simons, Op. cit., p. 14.

Trial Balance
Able-Ball Distributing Co.
December 31, 1964

| | Debit | Credit |
|---|---|---|
| Cash. . . . . . . . . . . . | $ 17,050 | |
| Receivables--net. . . . . | 75,600 | |
| Equipment--net. . . . . . | 127,000 | |
| Other assets. . . . . . . | 30,350 | |
| Accounts Payable. . . . . | | $ 48,250 |
| Able, capital . . . . . . | | 60,000 |
| Able, drawing . . . . . . | 5,000 | |
| Ball, capital . . . . . . | | 55,000 |
| Ball, drawing . . . . . . | 6,500 | |
| Cole, capital . . . . . . | | 55,000 |
| Cole, drawing . . . . . . | 6,750 | |
| Sales . . . . . . . . . . | | 195,000 |
| Expenses. . . . . . . . . | 145,000 | |
| Totals . . . . . . | $413,250 | $413,250 |

Income Statement
Able-Ball Distributing Co.
December 31, 1964

| | |
|---|---|
| Net Sales. . . . . . . . . . . | $195,000 |
| Less Expenses. . . . . . . . . | 145,000 |
| Net profits . . . . . . . . | $ 50,000 |

Since the division of profits is to be based on average capitals for the year, calculations for determining partners' share of profits are presented.

| Partner | Date | Capital Balance | Months Unchanged | Months X Balance | Total Month Dollars |
|---|---|---|---|---|---|
| Able | 1/1/64 | $ 50,000 | 3 | $150,000 | |
| " | 4/1/64 | 52,000 | 2 | 104,000 | |
| " | 6/1/64 | 55,000 | 5 | 275,000 | |
| " | 11/1/64 | 58,000 | 1 | 58,000 | |
| " | 12/1/64 | 60,000 | 1 | 60,000 | $ 647,000 |
| | | | 12 | | |
| Ball | (calculations omitted). . . . . . . . . . . . . | | | | $ 591,000 |
| Cole | (calculations omitted). . . . . . . . . . . . . | | | | $ 562,000 |
| | TOTAL (all partners) . . . . . . . . . . . . . | | | | $1,800,000 |

Profits of $50,000 are distributed as follows:

Profit Distribution

| | | |
|---|---|---|
| Able: | 647,000/1,800,000 x 50,000 . . . | $ 18,000 |
| Ball: | 591,000/1,800,000 x 50,000 . . . | 16,500 |
| Cole: | 562,000/1,800,000 x 50,000 . . . | 15,500 |
| | Total . . . . . . . . . . . . . . . | $ 50,000 |

The entry to transfer the net profit to partners' capital accounts is as follows:

| | | |
|---|---|---|
| Net profit. . . . . . . . . . | $ 50,000 | |
| Able, capital. . . . . . . . . . . . | | $ 18,000 |
| Ball, capital. . . . . . . . . . . | | 16,500 |
| Cole, capital. . . . . . . . . . . | | 15,500 |

Sometimes the agreement permits partners to make cash or other asset withdrawals from the business. The trial balance previously presented shows that Able, Ball, and Cole withdrew $5,000, $6,500, and $6,750 respectively from the business during the current period. The original entries made at the time of withdrawals were as follows:

| | | |
|---|---|---|
| Able, drawing. . . . . . . . | $ 5,000 | |
| Ball, drawing. . . . . . . . | 6,500 | |
| Cole, drawing. . . . . . . . | 6,750 | |
| Cash . . . . . . . . . . . . | | $18,250 |

At the end of the accounting period, the drawings are deducted from the partners' capital account with the following entries.

| | | |
|---|---|---|
| Able, capital . . . . . . . . | $5,000 | |
| Ball, capital . . . . . . . . | 6,500 | |
| Cole, capital . . . . . . . . | 6,750 | |
| Able, drawing. . . . . . . . . . | | $5,000 |
| Ball, drawing. . . . . . . . . . | | 6,500 |
| Cole, drawing. . . . . . . . . | | 6,750 |

"In providing for the recognition of difference in personal contributions as well as for the recognition of other factors that are responsible for the success of the enterprise, it may be agreed that partners shall be allowed salaries, with any profit or loss balance after the allowance of salaries divided in some arbitrary ratio. The law makes no provisions for remuneration of partners services in the absence of any agreement thereto; however, the Uniform Partnership Act does provide that, in liquidations occasional by the death of a partner, a surviving partner is entitled to reasonable compensation for his services."[1]

Also, in providing for recognition of difference in investments and other factors, partners may allow interest on invested capital, with any profit or loss after allowance of interest divided according to the partnership agreement.

Partners may be allowed bonus for their services. The bonus may be considered as the first specified percentage of net profit, or it may be considered as an expense item.

It is now assumed that Able, Ball, and Cole share profits of $36,000 equally. Ball is allowed a bonus of 20% of net profits. If the bonus is treated as the first 20% of net profits, profits are distributed as follows:

| | Able | Ball | Cole | Total |
|---|---|---|---|---|
| Bonus (20% of $36,000) | | $ 7,200 | | $7,200 |
| Balance | $9,600 | 9,600 | $9,600 | 28,800 |
| Totals | $9,600 | $16,800 | $9,600 | $36,000 |

If the bonus is treated as an expense item, the $36,000 includes both the bonus and net profits. Therefore, $36,000 is 120% and net profit is 100% or $30,000 distributed as follows:

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[1] *Ibid.*, p. 20.

| | Able | Ball | Cole | Total |
|---|---|---|---|---|
| Bonus (20% of $30,000) | $ | $ 6,000 | $ | $ |
| Balance | 10,000 | 10,000 | 10,000 | 30,000 |
| Totals | $10,000 | $16,000 | $10,000 | $30,000 |

When the bonus is treated as an expense item, it may be computed as follows:

Let $X$ = net profit after deduction of the bonus

and $.20X$ = the bonus allowed to Ball

then $1.20X = \$36,000$

or $X = \dfrac{\$36,000}{1.20}$

$X = \$30,000$ (net profit after bonus)

therefore

$.20(30,000) = \$6,000$ (bonus allowed to Ball)

In the event of losses, they are treated in the same manner as profits, except that they will decrease partners' capital account according to the partnership agreement.

## CHAPTER IV

## DISSOLUTION AND LIQUIDATION OF THE PARTNERSHIP

### Causes of Dissolution

Dissolution always involves a change in the relationship of the partners, but does not always end the partnership business. Upon dissolution, the partnership is terminated but business activities are continued until all affairs of the partnership have been completed. A partnership may be dissolved for various reasons, some of which are presented in the following paragraphs.

First, dissolution may be caused by the actions of the partners. That is, a partnership may be dissolved as a result of the original, or sometimes, subsequent agreement, such as "by the passing of the period for which the relationship was (originally or subsequently agreed) to continue or by the performance of the object for which it was organized."[1] As shown earlier, a partner may withdraw from a partnership at any time, as long as such withdrawal does not violate the partnership agreement, or unless such withdrawal would do damage to the firm. The withdrawal, or the expulsion of a partner always dissolves the partnership. According to Section 27 of the Uniform Partnership Act, a partnership is not dissolved when one partner transfers his interest to a third person. However, "a minority of (the) states follow the contrary rule of the

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[1] Ronald A. Anderson, Op. cit., p. 677.

common law under which such sales (or transfers) dissolved the firm."[1]

Second, a partnership may be dissolved by the operations of the statutes. That is, a partnership is dissolved upon the death of any partner, even if the remaining partners continue to conduct the usual business. When a partner of a firm, or the partnership itself becomes bankrupt, such a partnership is dissolved. War may dissolve a partnership if such was is fought between governments to which different partners owe allegiance. A partnership is dissolved when the activities of such partnership are unlawful, or when some event occurs which make such partnership unlawful, or when some event occurs which make such partnership unlawful. For example, "when it is made unlawful by statutes for judges to engage in the practice of law, a firm is dissolved when one of its members becomes a judge."[2]

Finally, a partnership may be dissolved as a result of a court decree. Even where the agreement provides that the partnership shall continue for a long period of time, there are some situations which permit a partner to obtain a dissolution through a court decree. Some of such situations are as follows: A partner may have the partnership dissolved when his copartner becomes insane or of unsound mind. Also, when one partner becomes disable to the point where he can no longer perform his duties as a partner, the partnership may be dissolved. If one partner conducts himself in a way so as to prevent others from

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[1] Ibid., p. 677.

[2] Ibid., p. 678.

operating the partnership in its usual and ordinary manner, such partnership may be dissolved. That is, "a partner may obtain a decree of dissolution when another partner habitually or purposely commits a breach of the partnership contract or so conduct himself in matters relating to the partnership business that it is not reasonably practicable to carry on the business with him."[1] If the business cannot be operated at a profit, a court decree may be obtained. And finally, "a partnership may be dissolved as a result of any other circumstances that equitably call for a dissolution."[2] For example, if a partner induce a third person to join a partnership by fraudulant means, such partnership may be dissolved by the court.

## Statutory Requirements

When the partnership is dissolved by an act of a partner, notice must be given to the other partners unless his act clearly shows his intent to dissolve the firm. According to Section 34 of the Uniform Partnership Act, "where the dissolution is caused by the acts, death, or bankruptcy of a partner, each partner is liable to his copartner for his share of any liability created by any partner acting for the partnership as if the partnership had not been dissolved, unless (a) the dissolution being by the act of any partner, the partner acting for the partnership had knowledge of the dissolution, or (b) the dissolution being by the death or bankruptcy of a partner, the partner acting for the partnership had knowledge or notice of the death or bankruptcy."[3]

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[1] Ibid., p. 678.

[2] Ibid., p. 678.

[3] Uniform Partnership Act, 1914, Section 34.

Whether the partnership is dissolved as a result of an act by one partner, or an agreement by all partners, notice must be given to third persons. That is, actual or direct notice must be given to persons who conducted business with the partnership. And to persons who merely knew of the partnership but conducted no business therewith, notice may be given through any medias accessible to the general public, such as through newspapers, or placards in public places. Failure to give proper notices continues the power of each partner to bind his copartners, in respect to third persons, on contracts created within the ordinary conduct or scope of the partnership business.

To illustrate some consequences which may occur when partners fail to give proper notice of dissolution to third persons, the following case will be presented.

SECURITY STATE BANK OF BENSON vs. NELSON
Supreme Court of Minnesota, 1927

> Seven persons, Nelson being one, signed an agreement forming a partnership called the Sales Cash Company. The stated purpose was to buy the stock of the Benson Mercantile Company and close it out. Each person paid in $500 each. One of the members, Christ Hagan, managed the partnership. The stock was purchased and notes given to the plaintiff, Bank of Benson, for $5,000 to pay for the same. Another note was given to the Bank of Benson. This note amounted to $4,000. The business failed and the bank sued all original partners.
>
> Nelson, the defendant, contended that he sold his share in the partnership to Hagen shortly after creation, which was in February, 1922. Nelson sold his interest in April, 1922. The five remaining partners testified to not being informed of appellant's deal with Hagen until in April, 1923. The lower court ruled in favor of plaintiff.[1]

The Security State Bank of Benson had received notes of the

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[1] Paul P. Ashley, Op. cit., p. 878.

partnership immediately after its creation, at which time all partners were liable on such notes. If the partnership is dissolved without notifying the bank, all of the original partners are liable on any subsequent notes also. According to the statement issued by the court, "there (can) be (no) defense in the fact that, when the loans were obtained from the plaintiff, it was not willing to have appellant as an endorser or guarantor on (any subsequent) partnership notes, since it already had appellant's obligations (before dissolution) to the full extent permitted by law."[1] Had proper notice of dissolution been given to the bank, and to all copartners, Nelson would not have been liable, for partnership debts arising after the sale of his interest. However, since such was not the case, the Supreme Court of Minnesota affirmed that Nelson was liable, alone with his copartners, for the debts of the partnership.

## Accounting for Dissolution

As stated earlier, the withdrawal of a partner may cause the termination of the partnership business. However, the business may continue to operate as usual, settlement being made to a withdrawing partner by the purchase of his interest by remaining partners, or by a transfer of firm assets in satisfaction of his interest. The purchase of a withdrawing partner's interest by a remaining partner merely transfers the retiring partner's capital account to the capital account of the purchasing partner. No entry is made on the firm books other than the adjustment of capital accounts since this is really an outside transaction.

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[1] *Ibid.*, p. 879.

A withdrawing partner may demand an asset settlement in excess of his capital balance, especially if he had been very prosperous with the business. Instead of possibly interrupting business activities, the remaining partners may agree to make such a settlement. They may agree that the excess shall be considered as a bonus for the withdrawing partner, or as a creation of goodwill.

Assume that Able, Ball, and Cole share profits and losses in the ratio of 2:1:1 respectively, and that capital accounts are $30,000, $20,000, and $15,000 respectively. Cole desires to withdraw with the consent of Able and Ball who agree to pay Cole $17,000 for his interest in the firm, the excess of $2,000 being given in consideration of valuable services rendered.

The following illustrations will present entries to record Cole's withdrawal using the bonus and goodwill method.

<u>BONUS METHOD</u>. When the excess of $2,000 is considered as a bonus, it is charged to Able and Ball in the ratio of 2:1 as shown in the entry to establish firm liability below.

| | | |
|---|---|---|
| Cole, capital. . . . . . . . . | $15,000 | |
| Able, capital. . . . . . . . . . | 1,333.33 | |
| Ball, capital. . . . . . . . . . | 666.67 | |
| Payable to Cole. . . . . | | $17,000 |

<u>GOODWILL METHOD</u>--1. Since Cole shares profits to the extent of 25%, the excess of $2,000 will represent ¼ of the firm goodwill, and total goodwill will equal $8,000. The entry to distribute firm goodwill is:

| | | |
|---|---|---|
| Goodwill. . . . . . . . . . . . | $8,000 | |
| Able, capital. . . . . . . . . . | | $4,000 |
| Ball, capital. . . . . . . | | 2,000 |
| Cole, capital. . . . . . . | | 2,000 |

The entry to establish firm liability is:

| | | |
|---|---|---|
| Cole, capital. . . . . . . | $17,000 | |
| Payable to Cole . . . . | | $17,000 |

GOODWILL METHOD--2. The partners may desire to establish goodwill to the extent of the $2,000 excess only. The entry to record such is as follows:

| | | |
|---|---|---|
| Cole, capital. . . . . . . | $15,000 | |
| Goodwill . . . . . . . . . . | 2,000 | |
| Payable to Cole . . . . | | $17,000 |

Continuing the previous example, suppose that Cole was not so properous with the firm, and that he accepts $13,000 for his interest in the firm. The difference of settlement and actual capital balance, $2,000, may be considered as (1) a bonus to the remaining partners, or it may be considered as (2) a reduction in existing goodwill only, or (3) a reduction in existing goodwill and remaining partners' capital accounts.

Illustrations of the three methods are presented below.

BONUS METHOD. When the difference is considered as a bonus to the remaining partners, the entry to record liability is as follows:

| | | |
|---|---|---|
| Cole, capital. . . . . . . | $15,000 | |
| Payable to Cole . . . . | | $13,000 |
| Able, capital. . . . .. . | | 1,333.33 |
| Ball, capital . . . . . | | 666.67 |

GOODWILL METHOD--1. The $2,000 difference may be deducted from existing goodwill balance - if any. Assuming there is existing goodwill, the entry to record the settlement is as follows:

| | | |
|---|---|---|
| Cole, capital. . . . . . . | $15,000 | |
| Goodwill. . . . . . . . . | | $ 2,000 |
| Payable to Cole . . . . | | 13,000 |

GOODWILL METHOD--2. Since Cole shares profits and losses to the extent of 25%, $2,000, the difference in settlement and capital balance represents 25% of total goodwill reduction. The entry to record goodwill reduction and to establish firm liability is as follows:

| | | |
|---|---|---|
| Cole, capital. . . . . . . . | $15,000 | |
| Able, capital. . . . . . . . | 4,000 | |
| Ball, capital. . . . . . . . | 2,000 | |
| Goodwill. . . . . . . . . | | $ 8,000 |
| Payable to Cole . . . . | | 13,000 |

The remaining partners may pay the withdrawing partner in a lump sum, or in installments agreed upon by all parties. When the liability is discharged by installments, it is treated as any other liability. Interest is generally charged on outstanding balances.

## Accounting for Liquidation

What is liquidation, and what are the steps involved therein? According to Finney, "in a narrow sense liquidation means the payment of a liability. But in a broad sense, liquidation means the process of winding up a business, converting assets into cash or other distributable assets, by sale of business or by piecemeal realization, disposing of the liabilities by payment or through their assumption by the purchaser of the business, and distributing the remaining cash (or other distributable assets) to the partners."[1]

Before any assets are distributed among the partners, the liabilities of the firm must be paid. After all outside creditors are paid, first, each partner is entitled to a refund of advances made to or for the partnership. Next, partners' capital contributions are returned. Finally, if there are any assets left, they are divided among the partners according to agreement, or equally in the absence of agreement.

Assume that on June 1, 1965, the Able-Ball Distributing Company was forced to liquidate. Able, Ball, and Cole share profits and losses in the ratio of 5:3:2, respectively. A balance sheet as of June 1, is below.

Able-Ball Distributing Company
Balance Sheet
June 1, 1965

| Assets: | | Liabilities and Capital: | |
|---|---|---|---|
| Cash. . . . . . . | $ 5,000 | Accounts payable. . . . | $ 89,500 |
| Other assets. . . | 321,000 | Able, Loan. . . . . . . | 15,500 |
| | | Cole, Loan. . . . . . . | 7,000 |
| | | | 112,000 |
| | | Able, Capital . . . . . | 76,000 |
| | | Ball, Capital . . . . . | 73,000 |
| | | Cole, Capital . . . . . | 65,000 |
| | $326,000 | | $326,000 |

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[1]H. A. Finney, Principles of Accounting--Advanced (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1961), p. 34.

By June 28, 1965, the firm was completely liquidated. Schedules showing the computation of partners' individual interest and the statement of liquidation are presented below.

Schedule A
Computation of Partners' Interest
(Amounts to be paid to Partners)

| Item | Able | Ball | Cole |
|---|---|---|---|
| Percentage of ownership | 50% | 30% | 20% |
| Balance before cash distribution | $ 51,000 | $ 58,000 | $ 55,000 |
| Add: Loan balances . . . . . . . | 15,500 | -0- | 7,000 |
| Free Interest. . . . . . . . . . | $ 76,500 | $ 58,000 | $ 62,000 |
| Amount to apply on loans. . . . | $ 15,500 | $ -0- | $ 7,000 |
| Amount to apply on capitals . . | 51,000 | 58,000 | 55,000 |
| Total Distribution . . . . . . . . | $ 76,500 | $ 58,000 | $ 62,000 |

Statement of Liquidation
June 28, 1965

| Item | Cash and Assets | Creditors & Loans | Able | Capitals Ball | Cole |
|---|---|---|---|---|---|
| Balance before liquidation | $326,000 | $112,000 | $76,000 | $73,000 | $65,000 |
| Sold assets* & shared loss | - 50,000 | | -25,000 | -15,000 | -10,000 |
| Balances: | 276,000 | 112,000 | 51,000 | 58,000 | 55,000 |
| Paid Creditors | -89,500 | -89,500 | | | |
| Paid Loans | -22,500 | -22,500 | | | |
| Balances: | 164,000 | -0- | 51,000 | 58,000 | 55,000 |
| Paid Partners | -164,000 | | -51,000 | -58,000 | -55,000 |

*The firm incurred a $50,000 loss on sale of assets.

"In the course of liquidation, when a partner's capital account reports a debit balance and such partner has a loan balance, the law permits exercise of the right to offset, that is the offset of a part or all of the loan against the capital deficiency. A debit balance in the capital account in the absence of a loan balance indicates the need for a contribution by the deficient partner. Failure by a partnership to recover a capital deficiency will mean that remaining partners will have to absorb such deficiency."[1]

Assume that the Able-Ball Distributing Company was not so successful, and that Able had a debit balance in his capital account, while Ball and Cole had credit balances of $8,000 and $6,000 respectively. A balance sheet is presented below.

Balance Sheet

| Assets: | | Liabilities & Capitals: | |
|---|---|---|---|
| Cash. . . . . . . . | $ 5,000 | Liabilities. . . . . . | $ 8,000 |
| Other Assets. . . . | 13,000 | Able, Capital. . . . . | (4,000) |
| | | Ball, Capital. . . . . | 8,000 |
| | | Cole, Capital. . . . . | 6,000 |
| Totals | $18,000 | | $18,000 |

If Able contributes $4,000 to the firm now, his capital deficiency will be canceled. However, if he is unable to pay the deficiency, Ball and Cole will absorb the deficiency in the ratio of 2:1 as shown in the schedule showing the computation of partners' interest, followed by the statement of liquidation which shows the distribution of firm assets and additional investment of $4,000 made by Able to cover capital deficiency. Able, Ball, and Cole share profits and losses in the ratio of 50%, 25%

[1]Harry Simons, Op. cit., p. 69.

and 25%, respectively. Schedules to support the previous balance sheet follow.

Schedule A
Computation of Partners' Interest

| Item | Able | Ball | Cole |
|---|---|---|---|
| Percentage of ownership | 50% | 25% | 25% |
| Balance before cash distribution | $-4,000 | $ 8,000 | $ 6,000 |
| Restricted interest - possible loss of Able's deficiency . . . | 4,000 | -2,000 | -2,000 |
| Free Interest. . . . . . . . . . . | -0- | 6,000 | 4,000 |
| Payment to apply on loans. . . . | -0- | -0- | -0- |
| Payment to apply on capitals . . | $ -0- | $ 6,000 | $ 4,000 |

Statement of Liquidation
Able, Ball, and Cole

| Item | Cash & Assets | Creditors | Able 50% | Ball 25% | Cole 25% |
|---|---|---|---|---|---|
| Balance before Liquidation | $ 18,000 | $ 8,000 | $ -4,000 | $ 8,000 | $ 6,000 |
| Sold assets & paid creditors | -8,000 | -8,000 | | | |
| Balances | 10,000 | -0- | -4,000 | 8,000 | 6,000 |
| Paid to partners | -10,000 | | | -6,000 | -4,000 |
| Balances | -0- | | | 2,000 | 2,000 |
| Investment by Able | 4,000 | | 4,000 | | |
| Payment to partners | -4,000 | | | -2,000 | -2,000 |
| Balances | -0- | -0- | -0- | -0- | -0- |

If Able had never paid the $4,000 to the firm, it would have been permanently charged against the capitals of the remaining partners in the profit and loss sharing ratio existing among them.

In the first two illustrations, total loss on assets and total capital deficiency were determined at the time of the first and only settlement, at which time, losses and capital deficiency were known and distributed among the partners in their proper profit and loss sharing ratios.

When distribution is made in installments, the amoung that will be realized on remaining assets is not known. Therefore, future gains or losses are not known. For these reasons, each installment or distribution should be made as if it were the last, all remaining assets being considered loss. Simons states that "such an assumption calls for the recognition of: (1) the possibility of a total loss on all remaining assets, and (2) the possibility that deficient partners or potentially deficient partners may be unable to meet their indebtness to the firm. The practical effect of such a procedure is to provide distributions that (will) bring partners' interest into profit and loss ratio as rapidly as possible. Once the profit and loss ratio is achieved, further distributions can be made in the profit and loss ratio. The partners' interest will thus remain in the profit and loss ratio and be able to absorb properly any future loss."[1]

In considering a loss on all remaining assets, it may be found that the interest of certain partners are inadequate to meet such an occurrence. In these instances, it will be necessary to consider the possibility that partners with deficient balances may not be able to meet their indebtness to the firm. When such is the case, the first distribution will not bring the partners' interest into the profit and

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[1] Ibid., p. 93.

ratios. Each distribution, however, will bring partners' interest closer to the profit and loss sharing ratio.

In the previous examples there was only one installment to partners, at which time the profit and loss sharing ratio was obtained. Now assume that Able, Ball, and Cole share profits and losses in the ratio of 2:1:1, respectively. A balance sheet as of liquidation is presented below.

Able, Ball and Cole
Balance Sheet

| Assets: | | Liabilities and Capitals: | |
|---|---|---|---|
| Cash. . . . . . . . | $ 10,000 | Accounts Payable. . . . . | $ 80,000 |
| Other Assets. . . | 180,000 | | |
| | | Able, Capital . . . . . . | 48,000 |
| | | Ball, Capital . . . . . . | 34,000 |
| | | Cole, Capital . . . . . . | 28,000 |
| Totals . . . | $190,000 | | $190,000 |

Asset sale and realization were as follows:

Sale of Assets

| Date | Book Value | Realization | Loss | Asset Balance |
|---|---|---|---|---|
| January 1, | $ 30,000 | $ 26,000 | $ 4,000 | $ 150,000 |
| March 1, | 60,000 | 54,000 | 6,000 | 90,000 |
| June 1, | 20,000 | 18,000 | 2,000 | 70,000 |
| August 1, | 70,000 | 65,000 | 5,000 | -0- |

Schedules to accompany statement of liquidation are presented below.

Schedule A

| Item | Able-50% | Ball-25% | Cole-25% |
|---|---|---|---|
| Balance before distribution. . . | $ 43,000 | $ 31,500 | $ 25,500 |
| Add: Loan balances. . . . . . . | -0- | -0- | -0- |
| | $ 43,000 | $ 31,500 | $ 25,500 |
| Restricted interest--possible loss of remaining assets ($90,000) | -45,000 | -22,500 | -22,500 |
| Balances. . . . . . . . . . . . . | - 2,000 | 9,000 | 3,000 |
| Restricted (Able's deficiency) . | 2,000 | -1,000 | -1,000 |
| Free Interest. . . . . . . . . . | $ -0- | $ 8,000 | $ 2,000 |

Schedule B

| Item | Able-50% | Ball-25% | Cole-25% |
|---|---|---|---|
| Balance before distribution. . . . . . | $ 42,000 | $ 23,000 | $ 23,000 |
| Add: Loan balances. . . . . . . . . . . | -0- | -0- | -0- |
| | $ 42,000 | $ 23,000 | $ 23,000 |
| Restricted interest - possible loss of remaining assets ($70,000) . . . . . | -35,000 | -17,500 | -17,500 |
| Free interest. . . . . . . . . . . . . . | 7,000 | 5,500 | 5,500 |

Statement of Liquidation

| Item | Cash & Assets | Creditors | Able 50% | Ball 25% | Cole 25% |
|---|---|---|---|---|---|
| Bal. before Liquidation . . . | $ 190,000 | $ 80,000 | $ 48,000 | $ 34,000 | $ 28,000 |
| Loss on January sale . . . . . . . | -4,000 | | -2,000 | -1,000 | -1,000 |
| Balances . . . . . | $ 186,000 | | $ 46,000 | $ 33,000 | $ 27,000 |
| Payment to creditors . . . . | -36,000 | -36,000 | | | |
| Balances . . . . . | 150,000 | 44,000 | | | |
| Loss on March sale . . . . . . | -6,000 | | -3,000 | -1,500 | -1,500 |
| Balances . . . . . | 144,000 | | 43,000 | 31,500 | 25,500 |
| Paid creditors . . | -44,000 | -44,000 | | | |
| Installment: See Schedule A . . . | -10,000 | | | -8,000 | -2,000 |
| Balances . . . . . | 90,000 | -0- | | 23,500 | 23,500 |
| Loss on June Sale. | -2,000 | | -1,000 | - 500 | - 500 |
| Balances . . . . . | 88,000 | | 42,000 | 23,000 | 23,000 |
| Installment: See Schedule B. . . . | -18,000 | | -7,000 | -5,500 | -5,500 |
| Balances . . . . . | 70,000 | | 35,000 | 17,500 | 17,500 |
| Loss in August . . | - 5,000 | | -2,500 | -1,250 | -1,250 |
| Balances . . . . . | 65,000 | | 32,500 | 16,250 | 16,250 |
| Last Installment . | -65,000 | | -32,500 | -16,250 | -16,250 |
| Balances . . . . . | -0- | -0- | -0- | -0- | -0- |

Note: The schedule showing the sale of assets should be consult in studying the statement of liquidation and accompanying schedules.

# CHAPTER V

## SUMMARY

The average individual today takes much pride in the fact of his ownership of various forms of property. If a businessman takes pride in the ownership of property and has a strong desire to control all the activities associated with such property, he may be advised to create his own individual proprietorship. If, however, the businessman wanting to own and control his property found another person in whom he had complete confidence, he might enter into a business partnership instead. Here both ownership and control will be shared. And liabilities incurred by either partner will bind both partners. Either partner could be forced to give up all personal belongings in satisfaction of firm debts.

Therefore, the difficulty of creating a partnership lies in the selection of a partner. This is one of the most important steps in the creation of a partnership. Not only must the partner possess the assets or skills that the partnership needs, but also it is important that he be honest and dependable, with a personality that will minimize internal friction - as well as friction from the outside. Two heads put together may be better than one, but two heads fighting against each other make very little progress.

If the dissatisfaction of one partner becomes intolerable, his withdrawal is enough to dissolve the partnership. However, the firm may continue to operate by accepting a new partner or by purchase of the withdrawing partner's interest by a remaining partner. But sometimes it is not easy to replace a withdrawing partner's assets nor skill, and in such case, not only legal dissolution, but economic dissolution may occur also.

At the time of creation, the task of evaluating partners may arise often with respect to revaluation of the interest of partners, as a result of a partner dying or withdrawing, or as a result of a new partner coming into the partnership. Some partners may be more mature and stable that others, and their abilities may differ considerably. Some partners may have great abilities to secure new customers, while others may become specialists in taxation, or some other phase of the partnership which has resulted in promoting the reputation and success of the business. The presence of these factors contributes considerably to the creation of firm goodwill, a value assigned to a business over and above its physical assets.

When a partner invests assets into a firm, he is given credit for an amount equal to, greater than, or less than the value of the asset contribution, such variations, if any, depending on the influence of factors such as abilities and a partners reputation. Where the interest received is less than the actual asset contribution, the difference may be considered as a bonus to the other partners. However, this may cause some conflict among the partners if the contributing partner refuses to have his capital ccount appear in an amount less that of the asset contribution. Also, in the case of a bonus to the new partner, or contributing partner, the remaining partner may refuse to have their capital accounts reduced. In such cases it may be wise to establish firm goodwill. Although the capital relationship will be the same in either case, the dollar value of the capital accounts will always remain the same or be adjusted upward when the goodwill method is used.

The problem of assigning interests to incoming partners may become troublesome with an existing firm with two or more partners, and a firm that is well established with regular customers and a good business connection. Then one may ask why a firm admits a new partner to an existing partnership. There are many reasons. For example: A firm may desire to keep those employees who have reached the stage of growth where they are somewhat indispensable as to technical abilities, the ability to impress and sell themselves to the customers, and, maybe, the ability to develop their own business. The admission of these workers may maintain continuity and stability of the present partnership.

Consideration must now be given to the problem of whether or not the incoming partner should be charged for his interest, and if so, how much. Sometimes the firm makes no charge against an incoming partner, permitting him to build up his interest through undrawn profits. But where some charge is made, there is the problem of computing such interest, and determining whether or not it should include goodwill or a bonus.

Prevailing accounting procedures for recording bonuses and goodwill may not serve as an adequate source of reference, in respect to the composition of partners' capital accounts. That is, when a partner is given a bonus, or goodwill is credited to his account as a result of the admission of a new partner, the extent of such bonus or credit is merely transferred to the existing capital of the former. Also, when goodwill is created, no explanations are given in the accounts as to the original of, or how such goodwill was distributed. Therefore it is suggested here that separate accounts be established for bonus and goodwill consideration, the source of such being stated in the capital accounts.

Suggested methods for recording goodwill and bonus are presented in the succeeding chapters.

As shown in the examples in Chapter II, suppose Cole's investment of $50,000 into an existing firm which has a net worth of $120,000 makes total net worth of $170,000. Cole received a 25 per cent interest in firm assets. To serve as a convenient and perpetual reference as to the composition of partners' capital account, the entry may appear as:

```
Cash. . . . . . .$50,000
  Able, Capital--Cole's Bonus. . .$ 4,125
  Ball, Capital--Cole's Bonus. . .  3,375
  Cole, Capital . . . . . . . .. . . 50,000
  Cole, Capital--Bonus . . . . . . . (7,500)
```

Assuming the creation of firm goodwill to be credited to Able's and Ball's capital accounts, Cole's investment may appear as:

```
Cash. . . . . . .$50,000
Goodwill. . . . . 30,000
  Able, Capital--Goodwill. . . .$16,500
  Ball, Capital--Goodwill. . . . 13,500
  Cole, Capital.. . . . . .. . . . 50,000
```

Now assuming that Cole, the new partner, is receiving a bonus, after Cole's investment of $40,000, the total net worth of the firm amounted to $130,000. Cole receives a one-third interest in firm assets. The entry to record Cole's investment may appear as:

```
Cash. . . . . . .$40,000
  Able, Capital--Cole's Bonus. . . .$(1,833.15)
  Ball, Capital--Cole's Bonus. . . . (1,499.85)
  Cole, Capital. . . . . . . . . . . 40,000.00
  Cole, Capital--Bonus . . . . . . .  3,333.00
```

Assuming that firm goodwill is created and credited to Cole's capital account, the entry may appear as:

```
Cash. . . . . . .$40,000
Goodwill. . . . .  5,000
  Cole, Capital. . . . . . .$40,000
  Cole, Capital--Goodwill. .  5,000
```

When using these procedures in accounting for bonuses and goodwill, the actual amount of asset contribution will always be shown. However, in respect to net worth, these "actual amounts" are subject to increase or decrease due to any credit or debit balances in the "Capital--Bonus" or "Capital--Goodwill" accounts, which incidently, will be shown in the Capital section of the balance sheet. A typical balance sheet may appear as follows:

| Assets: | | Liabilities: | |
|---|---|---|---|
| Cash. . . . . . . | $90,000 | Accounts Payable. . . . | $ 50,000 |
| Accounts Rec. . . | 30,000 | Other Payables. . . . . | 20,000 |
| Currents. . . . . | 40,000 | | |
| | | Capital: | |
| Equipment . . . . | 50,000 | Able, Capital . . . . . | 50,000 |
| | | Able, Capital-C's Bonus | 4,125 |
| | | Ball, Capital . . . . . | 40,000 |
| | | Ball, Capital-C's Bonus | 3,375 |
| | | Cole, Capital . . . . . | 50,000 |
| | | Cole, Capital-Bonus . . | (7,500) |
| | $210,000 | | $210,000 |

However, for publication purposes, only the net worth of each partner's capital may be presented. These same procedures may be employed in partnership dissolution, in respect to the withdrawal of a partner where consideration is given to bonuses or the creation of goodwill. That is, where consideration is given to partners' intangible possessions such as reputations and abilities.

But the value of each partner's personal intangible contributions cannot easily be evaluated. The effectiveness of the partners and their income producing abilities do not remain in the same relationship always. This may present some profits sharing problems. That is, a ratio for sharing profits and losses that is considered satisfactory today may be inadequate, say, three years hence, unless a provision for changes and modification in profits and loss sharing ratios is included in the partnership agreement. Some profit sharing ratios or methods that give some consideration to changes in the relationship of partners' contribution to the success of the firm are discussed in the succeeding chapters.

Profits may be divided in any arbitrary ratio desired by the partners. Therefore, partners may agree to divide profits on the basis of the relationship of partners' initial investments. That is, profits may be divided in the ratio of partners' capital at creation. The advantage of this method is that it is a very simple and easy way to distribute profits year after year. No adjustments need to be made for any changes in the ratio of partners' capital. However, this method does not give any consideration to any additional investments by any partner or any changes in the ratio of partners' capital balances. For example, say, Able, Ball and Cole entered a partnership, making initial investments of $5,000 each. Now suppose at the end of the third year, Able had made an additional investment of $5,000 without withdrawing any profits from the partnership; Ball had made no additional cash nor asset investment and withdrew no profits; and Cole withdrew profits but made no additional investment. Now suppose that their capital amounts to $12,000, 7,000 and 5,000, respectively. If profits hereafter are divided in the ratio of original investments, no consideration would be given to the changes in the relationship of these capital balances. Therefore, another method of dividing profits should be employed when such changes occur.

The dividing of profits in the ratio of partners' capital at the end or beginning of the year gives some consideration of the changes in capital balances--at least from year to year. When a partner increases his capital balance in relation to the balances of his copartner's capital, he also increases his share of profits in the same manner. Just the reverse occurs when there is a decrease in a capital balance.

Probably the most accurate, but most troublesome method of distributing profits is the average capital method. This method is illustrated in Chapter III of this report. Here profits are distributed among all partners in the ratio of average capital balances for the current period. This method not only considers the yearly changes in capital ratios, but the monthly changes also. When there is great fluctuations in capital balances, this method will best serve the purpose of distributing profits.

As for liabilities of the partnership, since all partners have the status of principal, the law adequately provides that they be jointly liable on partnership debts. If, for example, two partners created a business and purchased large quantities of goods on account, they could make unjust profits by merely refusing to pay for such goods--that is, without unlimited liability. To illustrate, suppose two partners invested $5,000 each into a business. Later, they purchased $25,000 worth of merchandise on account. By unlawful means, they could transfer, say, $19,000 worth of this merchandise to their personal holdings, making a "profit" of $9,000. If they become "insolvent", without the principles of unlimited liability, they would be liable only to the extent of assets remaining in the business. Therefore, the statutes which establishes unlimited liability for partnerships discourages the creation of partnerships for conducting fraudulent activities.

Finally, there are many reasons why the partnership is created. The ease of its formation and the flexibility of adjustment of contractual relationship among partners make the partnership a convenient method for pooling assets and uniting the business interest of two or more individuals. But as shown in this report, the business of the partnership may become very complicated, especially where partners do not adhere to prevailing legal and accounting principles governing their association. It is not suggested or implied that all problems of the partnership will vanish if these principles were followed, because problems, to some extent, in any business are inevitable. But if such be the case, many of the problems that exist would be considerably reduced, and the partnership can then take its rightful place in the business world by aplying more of its resources to the development and growth of the community in which it exists.

APPENDIX

# UNIFORM PARTNERSHIP ACT



## PART I

### Preliminary Provisions

Section 1. (Name of Act.) This act may be cited as Uniform Partnership Act.

Section 2. (Definition of Terms.) In this act, "Court" includes every court and judge having jurisdiction in the case.

"Business" includes every trade, occupation, or profession.

"Person" includes individuals, partnerships, corporations, and other associations.

"Bankrupt" includes bankrupt under the Federal Bankruptcy Act or insolvent under any state insolvent act.

"Conveyance" includes every assignment, lease, mortgage, or encumbrance.

"Real property" includes land and any interest or estate in land.

Section 3. (Interpretation of Knowledge and Notice.) (1) A person has "knowledge" of a fact within the meaning of this act not only when he has actual knowledge thereof, but also when he has knowledge of such other facts as in the circumstances shows bad faith.

(2) A person has "notice" of a fact within the meaning of this act when the person who claims the benefit of the notice:

(a) States the fact to such person, or
(b) Delivers through the mail, or by other means of communication, a written statement of the fact to such person or to a proper person at his place of business or residence.

Section 4. (Rules of Construction.) (1) The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this act.

(2) The law of estoppel shall apply under this act.

(3) The law of agency shall apply under this act.

(4) This act shall be so interpreted and construed as to effect its general purpose to make uniform the law of those states which enact it.

(5) This act shall not be construed so as to impair the obligations of any contract existing when the act goes into effect, nor to affect any action or proceedings begun or right accrued before this act takes effect.

Section 5. (Rules for Cases not Provided for in this Act.) In any case not provided for in this act the rules of law and equity, including the law merchant, shall govern.

## PART II

### Nature of a Partnership

Section 6. (Partnership Defined.) (1) A partnership is an association of two or more persons to carry on as co-owners a business for profit.

(2) But any association formed under any other statute of this state, or any statute adopted by authority, other than the authority of this state, is not a partnership under this act, unless such association would have been a partnership in this state prior to the adoption of this act; but this act shall apply to limited partnerships except in so far as the statutes relating to such partnerships are inconsistent herewith.

Section 7. (Rules for Determining the Existence of a Partnership.) In determining whether a partnership exists, these rules shall apply:

(1) Except as provided by Section 16 persons who are not partners as to each other are not partners as to third persons.

(2) Joint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership does not of itself establish a partnership, whether such co-owners do or do not share any profits made by the use of the property.

(3) The sharing of gross returns does not of itself establish a partnership, whether or not the persons sharing them have a joint or common right or interest in any property from which the returns are derived.

(4) The receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner in the business, but no such inference shall be drawn if such profits were received in payment:

(a) As a debt by installment or otherwise,
(b) As wages of an employee or rent to a landlord,
(c) As an annuity to a widow or representative of a deceased partner,
(d) As interest on a loan, though the amount of payment vary with the profits of the business.
(e) As the consideration for the sale of a goodwill of a business or other property by installments or otherwise.

Section 8. (Partnership Property.) (1) All property originally brought into the partnership stock or subsequently acquired by purchase or otherwise, on account of the partnership, is partnership property.

(2) Unless the contrary intention appears, property acquired with partnership funds is partnership property.

(3) Any estate in real property may be acquired in the partnership name. Title so acquired can be conveyed only in the partnership name.

(4) A conveyance to a partnership in the partnership name, though without words of inheritance, passes the entire estate of the grantor unless a contrary intent appears.

## PART III

### Relations of Partners to Persons Dealing with the Partnership

Section 9. (Partner Agent of Partnership as to Partnership Business.) (1) Every partner is an agent of the partnership for the purpose of its business, and the act of every partner, including the execution in the partnership name of any instrument, for apparently carrying on in the usual way the business of the partnership of which he is a member binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom he is dealing has knowledge of the fact that he has no such authority.

(2) An act of a partner which is not apparently for the carrying on of the business of the partnership in the usual way does not bind the partnership unless authorized by the other partners.

(3) Unless authorized by the other partners or unless they have abandoned the business, one or more but less than all the partners have no authority to:

(a) Assign the partnership property in trust for creditors or on the assignee's promise to pay the debts of the partnership,
(b) Dispose of the good-will of the business,
(c) Do any other act which would make it impossible to carry on the ordinary business of a partnership,
(d) Confess a judgment,
(e) Submit a partnership claim or liability to arbitration or reference.

(4) No act of a partner in contravention of a restriction on authority shall bind the partnership to persons having knowledge of the restriction.

Section 10. (Conveyance of Real Property of the Partnership.) (1) Where title to real property is in the partnership name, any partner may convey title to such property by a conveyance executed in the partnership name, but the partnership may recover such property unless the partner's act binds the partnership under the provisions of paragraph (1) of section 9 or less such property has been conveyed by the grantee or a person claiming through such grantee to a holder for value without knowledge that the partner, in making the conveyance, has exceeded his authority.

(2) Where title to real property is in the name of the partnership, a conveyance executed by a partner, in his own name, passes the equitable interest of the partnership, provided the act is one within the authority of the partner under the provisions of paragraph (1) of section 9.

(3) Where title to real property is in the name of one or more but not all the partners, and the record does not disclose the right of the partnership, the partners in whose name the title stands may convey title to such property, but the partnership may recover such property if the partners' act does not bind the partnership under the provisions of paragraph (1) of section 9, unless the

purchaser or his assignee, is a holder for value, without knowledge.

(4) Where the title to real property is in the name of one or more or all the partners, or in a third person in trust for the partnership, a conveyance executed by a partner in the partnership name, or in his own name, passes the equitable interest of the partnership, provided the act is one within the authority of the partner under the provisions of paragraph (1) of section 9.

(5) Where the title to real property is in the names of all the partners a conveyance executed by all the partners passes all their rights in such property.

Section 11. (Partnership Bound by Admission of Partner.) An admission or representation made by any partner concerning partnership affairs within the scope of his authority as conferred by this act is evidence against the partnership.

Section 12. (Partnership Charged with Knowledge of or Notice to Partner.) Notice to any partner of any matter relating to partnership affairs, and the knowledge of the partner acting in the particular matter, acquired while a partner or then present to his mind, and the knowledge of any other partner who reasonably could and should have communicated it to the acting partner, operate as notice to or knowledge of the partnership, except in the case of a fraud on the partnership committed by or with the consent of that partner.

Section 13. (Partnership Bound by Partner's Wrongful Act.) Where, by any wrongful act or omission of any partner acting in the ordinary course of the business of the partnership or with the authority of his co-partners, loss or injury is caused to any person, not being a partner in the partnership, or any penalty is incurred, the partnership is liable therefor to the same extent as the partner so acting or omitting to act.

Section 14. (Partnership Bound by Partner's Breach of Trust.) The partnership is bound to make good the loss:

(a) Where one partner acting within the scope of his apparent authority receives money or property of a third person and misapplies it; and
(b) Where the partnership in the course of its business receives money or property of a third person and the money or property so received is misapplied by any partner while it is in the custody of the partnership.

Section 15. (Nature of Partner's Liability.) All partners are liable

(a) Jointly and severally for everything chargeable to the partnership under sections 13 and 14.
(b) Jointly for all other debts and obligations of the partnership; but any partner may enter into a separate obligation to perform a partnership contract.

Section 16. (Partner by Estoppel.) (1) When a person, by words spoken or written or by conduct, represents himself, or consents to another representing him to any one, as a partner in an existing partnership or with one or more persons not actual partners, he is liable to any such person to whom such representation has been made, who has, on the faith of such representation, given credit to the actual or apparent partnerships, and if he has made such representation or consented to its being made in a public manner he is liable to such person, whether the representation has or has not been made or communicated to such person so giving credit by or with the knowledge of the apparent partner making the representation or consenting to its being made.

(a) When a partnership liability results, he is liable as though he were an actual member of the partnership.
(b) When no partnership liability results, he is liable jointly with the other persons, if any, so consenting to the contract or representation as to incur liability, otherwise separately.

(2) When a person has been thus represented to be a partner in an existing partnership, or with one or more persons not actual partners, he is an agent of the persons consenting to such representation to bind them to the same extent and in the same manner as though he were a partner in fact, with respect to persons who rely upon the representation. Where all the members of the existing partnership consent to the representation, a partnership act or obligation results; but in all other cases it is the joint act or obligation of the person acting and the persons consenting to the representation.

Section 17. (Liability of Incoming Partner.) A person admitted as a partner into an existing partnership is liable for all the obligations of the partnership arising before his admission as though he had been a partner when such obligations were incurred, except that this liability shall be satisfied only out of partnership property.

## PART IV

### Relations of Partners to One Another

Section 18. (Rules Determining Rights and Duties of Partners.) The rights and duties of the partners in relation to the partnership shall be determined, subject to any agreement between them, by the following rules:

(a) Each partner shall be repaid his contributions, whether by way of capital or advances to the partnership property and share equally in the profits and surplus remaining after all liabilities, including those to partners, are satisfied; and must contribute towards the losses, whether of capital or otherwise, sustained by the partnership according to his share in the profits.
(b) The partnership must indemnify every partner in respect of payments made and personal liabilities reasonably incurred by him in the ordinary and proper conduct of its business, or for the preservation of its business or property.
(c) A partner, who in aid of the partnership makes any payment or advance beyond the amount of capital which he agreed to contribute, shall be paid interest from the date of the payment or advance.
(d) A partner shall receive interest on the capital contributed by him only from the date when repayment should be made.
(e) All partners have equal rights in the management and conduct of the partnership business.
(f) No partner is entitled to remuneration for acting in the partnership business, except that a surviving partner is entitled to reasonable compensation for his services in winding up the partnership affairs.
(g) No person can become a member of a partnership without the consent of all the partners.
(h) Any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners; but no act in contravention of any agreement between the partners may be done rightfully without the consent of all the partners.

Section 19. (Duty of Partners to Render Information.) Partners shall render on demand true and full information of all things affecting the partnership to any partner or the legal representative of any deceased partner or partner under legal disability.

Section 20. (Partnership Books.) The partnership books shall be kept, subject to any agreement between the partners, at the principal place of business of the partnership, and every partner shall at all times have access to and may inspect and copy any of them.

Section 21. (Partner Accountable as a Fiduciary.) (1) Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property.

(2) This section applies also to the representatives of a deceased partner engaged in the liquidation of the affairs of the partnership as the personal representatives of the last surviving partner.

Section 22. (Right to an Account.) Any partner shall have the right to a formal account as to partnership affairs:

(a) If he is wrongfully excluded from the partnership business or possession of its property by his co-partners,
(b) If the right exists under the terms of any agreement,
(c) As provided by section 21,
(d) Whenever other circumstances render it just and reasonable.

Section 23. (Continuation of Partnership Beyond Fixed Term.) (1) When a partnership for a fixed term or particular undertaking is continued after the termination of such term or particular undertaking without any express agreement, the rights and duties of the partners remain the same as they were at such termination, so far as is consistent with a partnership at will.

(2) A continuation of the business by the partners or such of them as habitually acted therein during the term, without any settlement or liquidation of the partnership affairs, is prima facie evidence of a continuation of the partnership.

## PART V

### Property Rights of a Partner

Section 24. (Extent of Property Rights of a Partner.) The property rights of a partner are (1) his rights in specific partnership property, (2) his interest in the partnership, and (3) his right to participate in the management.

Section 25. (Nature of a Partner's Right in Specific Partnership property.) (1) A partner is co-owner with his partners of specific partnership property holding as a tenant in partnership.

(2) The incidents of this tenancy are such that:

(a) A partner, subject to the provisions of this act and to any agreement between the partners, has an equal right with his partners to possess specific partnership property for partnership purposes; but he has no right to possess such property for any other purpose without the consent of his partners.

(b) A partner's right in specific partnership property is not assignable except in connection with the assignment of rights of all the partners in the same property.

(c) A partner's right in specific partnership property is not subject to attachment or execution, except on a claim against the partnership. When partnership property is attached for a partnership debt the partners, or any of them, or the representatives of a deceased partner, cannot claim any right under the homestead of exemption law.

(d) On the death of a partner his right in specific partnership property vests in the surviving partner or partners, except where the deceased was the last surviving partner, when his right in such property vests in his legal representative. Such surviving partner or partners, or the legal representative of the last surviving partner, has no right to possess the partnership property for any but a partnership purpose.

(e) A partner's right in specific partnership property is not subject to dower, curtesy, or allowances to widows, heirs, or next of kin.

Section 26. (Nature of Partner's Interest in the Partnership.) A partner's interest in the partnership is his share of the profits and surplus, and the same is personal property.

Section 27. (Assignment of Partner's Interest.)

(1) A conveyance by a partner of his interest in the partnership does not of itself dissolve the partnership, nor, as against the other partners in the absence of agreement, entitle the assignee, during the continuance of the partnership to interfere in the management or administration of the partnership business or affairs, or to require any information or account of partnership transactions, or to inspect the partnership books; but it merely entitles the assignee to receive in accordance with his contract the profits to which the assigning partner would otherwise be entitled.

(2) In case of a dissolution of the partnership, the assignee is entitled to receive his assignor's interest and may require an account from the date only of the last account agreed to by all the partners.

Section 28. (Partner's Interest Subject to Charging Order.) (1) On due application to a competent court by any judgment creditor of a partner, the court which entered the judgment, order, or decree, or any other court, may charge the interest of the debtor partner with payment of the unsatisfied amount of such judgment debt with interest thereon; and may then or later appoint a receiver of his share of the profits, and of any other money due or to fall due to him in respect of the partnership, and make all other orders, directions, accounts and inquiries which the debtor partner might have made, or which the circumstances of the case may require.

(2) The interest charged may be redeemed at any time before foreclosure, or in case of a sale being directed by the court may be purchased without thereby causing a dissolution:

(a) With separate property, by any one or more of the partners, or
(b) With partnership property, by any one or more of the partners with the consent of all the partners whose interests are not so charged or sold.

(3) Nothing in this act shall be held to deprive a partner of his right, if any, under the exemption laws, as regards his interest in the partnership.

## PART VI

### Dissolution and Winding Up

Section 29. (Dissolution Defined.) The dissolution of a partnership is the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business.

Section 30. (Partnership Not Terminated by Dissolution.) On dissolution the partnership is not terminated, but continues until the winding up of partnership affairs is completed.

Section 31. (Causes of Dissolution.) Dissolution is caused: (1) Without violation of the agreement between the partners,

(a) By the termination of the definite term or particular undertaking specified in the agreement,
(b) By the express will of any partner when no definite term or particular undertaking is specified,
(c) By the express will of all the partners who have not assigned their interests or suffered them to be charged for their separate debts, either before or after the termination of any specified term or particular undertaking,
(d) By the expulsion of any partner from the business bona fide in accordance with such a power conferred by the agreement between the partners;

(2) In contravention of the agreement between the partners, where the circumstances do not permit a dissolution under any other provision of this section, by the express will of any partner at any time;

(3) By any event which makes it unlawful for the business of the partnership to be carried on or for the members to carry it on in partnership;

(4) By the death of any partner;

(5) By the bankruptcy of any partner or the partnership;

(6) By decree of court under section 32.

Section 32. (Dissolution by Decree of Court.) (1) On application by or for a partner the court shall decree a dissolution whenever:

(a) A partner has been declared a lunatic in any judicial proceeding or is shown to be of unsound mind,

(b) A partner becomes in any other way incapable of performing his part of the partnership contract,

(c) A partner has been guilty of such conduct as tends to affect prejudicially the carrying on the business,
(d) A partner wilfully or persistently commits a breach of the partnership agreement, or otherwise so conducts himself in matters relating to the partnership business that it is not reasonably practicable to carry on the business in partnership with him,
(e) The business of the partnership can only be carried on at a loss,
(f) Other circumstances render a dissolution equitable.

(2) On the application of the purchaser of a partner's interest under sections 27 or 28:

(a) After the termination of the specified term or particular undertaking,
(b) At any time if the partnership was a partnership at will when the interest was assigned or when the charging order was issued.

Section 33. (General Effect of Dissolution on Authority of Partner.) Except so far as may be necessary to wind up partnership affairs or to complete transactions begun but not then finished, dissolution terminates all authority of any partner to act for the partnership,

(1) With respect to the partners,

(a) When the dissolution is not by the act, bankruptcy or death of a partner; or
(b) When the dissolution is by such act, bankruptcy or death of a partner, in cases where section 34 so requires.

(2) With respect to persons not partners, as declared in section 35.

Section 34. (Right of Partner to Contribution From Co-partners After Dissolution.) Where the dissolution is caused by the act, death or bankruptcy of a partner, each partner is liable to his copartners for his share of any liability created by any partner acting for the partnership as if the partnership had not been dissolved unless:

(a) The dissolution being by act of any partner, the partner acting for the partnership had knowledge of the dissolution, or
(b) The dissolution being by the death or bankruptcy of a partner, the partner acting for the partnership had knowledge or notice of the death or bankruptcy.

Section 35. (Power of Partner to Bind Partnership to Third Persons After Dissolution.) (1) After dissolution a partner can bind the partnership except as provided in Paragraph (3):

(a) By any act appropriate for winding up partnership affairs or completing transactions unfinished at dissolution;
(b) By any transaction which would bind the partnership if dissolution had not taken place, provided the other party to the transaction:

(I) Had extended credit to the partnership prior to dissolution and had no knowledge or notice of the dissolution; or

(II) Though he had not so extended credit, had nevertheless known of the partnership prior to dissolution, and, having no knowledge or notice of dissolution, the fact of dissolution had not been advertised in a newspaper of general circulation in the place (or in each place if more than one) at which the partnership business was regularly carried on.

(2) The liability of a partner under paragraph (1b) shall be satisfied out of partnership assets alone when such partner had been prior to dissolution:

(a) Unknown as a partner to the person with whom the contract is made; and
(b) So far unknown and inactive in partnership affairs that the business reputation of the partnership could not be said to have been in any degree due to his connection with it.

(3) The partnership is in no case bound by any act of a partner after dissolution:

(a) Where the partnership is dissolved because it is unlawful to carry on the business, unless the act is appropriate for winding up partnership affairs; or
(b) Where the partner has become bankrupt; or
(c) Where the partner has no authority to wind up partnership affairs; except by a transaction with one who:

(I) Had extended credit to the partnership prior to dissolution and had no knowledge or notice of his want of authority; or

(II) Had not extended credit to the partnership prior to dissolution, and, having no knowledge or notice of his want of authority; the fact of his want of authority has not been advertised in the manner provided for advertising the fact of dissolution in paragraph (1bII).

(4) Nothing in this section shall affect the liability under section 16 or any person who after dissolution represents himself or consents to another representing him as a partner in a partnership engaged in carrying on business.

Section 36. (Effect of Dissolution on Partner's Existing Liability.) The dissolution of the partnership does not of itself discharge the existing liability of any partner.

(2) A partner is discharged from any existing liability upon dissolution of the partnership by an agreement to that effect between himself, the partnership creditor and the person or partnership continuing the business; and such agreement may be inferred from the course of dealing between the creditor having knowledge of the dissolution and the person or partnership continuing the business.

Where a person agrees to assume the existing obligations of a dissolved partnership, the partners whose obligations have been assumed shall be discharged from any liability to any creditor of the partnership who, knowing of the agreement, consents to a material alteration in the nature or time of payment of such obligations.

(4) The individual property of a deceased partner shall be liable for all obligations of the partnership incurred while he was a partner but subject to the prior payment of his separate debts.

Section 37. (Right to Wind Up.) Unless otherwise agreed the partners who have not wrongfully dissolved the partnership or the legal representative of the last surviving partner, not bankrupt, has the right to wind up the partnership affairs; provided, however, that any partner, his legal representative or his assignee, upon cause shown, may obtain winding up by the court.

Section 38. (Rights of Partners to Application of Partnership Property.) (1) When dissolution is caused in any way, except in contravention of the partnership agreement, each partner as against his co-partners and all persons claiming through them in respect of their interests in the partnership, unless otherwise agreed, may have the partnership property applied to discharge its liabilities, and the surplus applied to pay in cash the net amount owing to the respective partners. But if dissolution is caused by expulsion of a partner, bona fide under the partnership agreement and if the expelled partner is discharged from all partnership liabilities, either by payment or agreement under section 36 (2), he shall receive in cash only the net amount due him from the partnership.

(2) When dissolution is caused in contravention of the partnership agreement the rights of the partners shall be as follows:

(a) Each partner who has not caused dissolution wrongfully shall have,

(I) All the rights specified in paragraph (1) of this section, and
(II) The right, as against each partner who has caused the dissolution wrongfully, to damages for breach of the agreement.

(b) The partners who have not caused the dissolution wrongfully, if they all desire to continue the business in the same name, either by themselves or jointly with others, may do so, during the agreed term for the partnership and for that purpose may possess the partnership property, provided they secure the payment by bond approved by the court, or pay to any partner who has caused the dissolution wrongfully, the value of his interest in the partnership at the dissolution, less any damages recoverable under clause (2aII) of the section, and in the like manner indemnify him against all present or future partnership liabilities.

(c) A partner who has caused the dissolution wrongfully shall have:

(I) If the business is not continued under the provisions of paragraph (2b) all the rights of a partner under paragraph (1), subject to clause (2aII), of this section,

(II) If the business is continued under paragraph (2b) of this section the right as against his co-partners shall claiming through them in respect of their interests in the partnership, to have the value of his interest in the partnership, less any damages caused to his co-partners by the dissolution, ascertained and paid to him in cash, or the payment secured by bond approved by the court, and to be released from all existing liabilities of the partnership; but in ascertaining the value of the partner's interest the value of the good-will of the business shall not be considered.

Section 39. (Rights Where Partnership is Dissolved for Fraud or Misrepresentation.) Where a partnership contract is rescinded on the ground of the fraud or misrepresentation of one of the parties thereto, the party entitled to rescind is, without prejudice to any other right, entitled,

(a) To a lien on, or right of retention of, the surplus of the partnership property after satisfying the partnership liabilities to third persons for any sum of money paid by him for the purchase of an interest in the partnership and for any capital or advances contributed by him; and
(b) To stand, after all liabilities to third persons have been satisfied, in the place of the creditors of the partnership for any payments made by him in respect of the partnership liabilities; and
(c) To be indemnified by the person guilty of the fraud or making the representation against all debts and liabilities of the partnership.

Section 40, (Rules for Distribution.) In settling all accounts between the partners after dissolution, the following rules shall be observed, subject to any agreement to the contrary:

(a) The assets of the partnership are;

(I) The partnership property,

(II) The contributions of the partners necessary for the payment of all the liabilities specified in clause (b) of this paragraph.

(b) The liabilities of the partnership shall rank in order of payment, as follows:

(I) Those owing to creditors other than partners,

(II) Those owing to partners other than for capital and profits,
(III) Those owing to partners in respect of capital,

(IV) Those owing to partners in respect of profits.

(c) The assets shall be applied in the order of their declaration in clause (a) of this paragraph to the satisfaction of the liabilities.

(d) The partners shall contribute, as provided by section 18 (a) the amount necessary to satisfy the liabilities; but if any, but not all, of the partners are insolvent, or, not being subject to process, refuse to contribute, the other parties shall contribute their share of the liabilities, and, in the relative proportions in which they share the profits, the additional amount necessary to pay the liabilities.

(e) An assignee for the benefit of creditors of any person appointed by the court shall have the right to enforce the contributions specified in clause (d) of this paragraph.

(f) Any partner or his legal representative shall have the right to enforce the contributions specified in clause (d) of this paragraph, to the extent of the amount which he has paid in excess of his share of the liability.

(g) The individual property of a deceased partner shall be liable for the contributions specified in clause (d) of this paragraph.

(h) When partnership property and the individual properties of the partners are in possession of a court for distribution, partnership creditors shall have priority on partnership property and separate creditors on individual property, saving the rights of lien or secured creditors as heretofore.

(i) Where a partner has become bankrupt or his estate is insolvent the claims against his separate property shall rank in the following order:

(I) Those owing to separate creditors,

(II) Those owing to partnership creditors,

(III) Those owing to partners by way of contribution.

Section 41. (Liability of Persons Continuing the Business in Certain Cases.) (1) When any new partner is admitted into an existing partnership, or when any partner retires and assigns (or the representative of the deceased partner assigns) his rights in partnership property to two or more of the partners, or to one or more of the partners and one or more third persons, if the business is continued without liquidation of the partnership affairs, creditors of the first or dissolved partnership are also creditors of the partnership so continuing the business.

(2) When all but one partner retire and assign (or the representative of a deceased partner assigns) their rights in partnership property to the remaining partner, who continues the business without liquidation of partnership affairs, either alone or with others, creditors of the dissolved partnership also creditors of the person or partnership so continuing the business.

(3) When any partner retires or dies and the business of the dissolved partnership is continued as set forth in paragraphs (1) and (2) of this section, with the consent of the retired partners or the representative of the deceased partner, but without any assignment of his right in partnership property, rights of creditors of the dissolved partnership and of the creditors of the person or partnership continuing the business shall be as if such assignment had been made.

(4) When all partners or their representatives assign their rights in partnership property to one or more third persons who promise to pay the debts and who continue the business of the dissolved partnership, creditors of the dissolved partnership are also creditors of the person or partnership continuing the business.

(5) When any partner wrongfully causes a dissolution and the remaining partners continue the business under the provisions of section 38 (2b), either alone or with others, and without liquidation of the partnership affairs, creditors of the dissolved partnership are also creditors of the person or partnership continuing the business.

(6) When a partner is expelled and the remaining partners continue the business either alone or with others, without liquidation of the partnership affairs, creditors of the dissolved partnership are also creditors of the person or partnership continuing the business.

(7) The liability of a third person becoming a partner in the partnership continuing the business, under this section, to the creditors of the dissolved partnership shall be satisfied out of partnership property only.

(8) When the business of a partnership after dissolution is continued under any conditions set forth in this section the creditors of the dissolved partnership, as against the separate creditors of the retiring or deceased partner or the representative of the deceased partner, have a prior right to any claim of the retired partner or the representative of the deceased partner against the person or partnership continuing the business, on account of the retired or deceased partner's interest in the dissolved partnership or an account of any consideration promised for such interest or for his right in partnership property.

(9) Nothing in this section shall be held to modify any right of creditors to set aside any assignment on the ground of fraud.

(10) The use by the person or partnership continuing the business of the partnership name, or the name of a deceased partner as part thereof, shall not of itself make the individual property of the deceased partner liable for any debts contracted by such person or partnership.

Section 42. (Rights of Retiring or Estate of Deceased Partner When the Business is Continued.) When any partner retires or dies, and the business is continued under way of the conditions set forth in section 41 (1, 2, 3, 5, 6), or section 38 (2b), without any settlement of accounts as between him or his estate and the person or partnership continuing the business, unless otherwise agreed, he or his legal representative as against such persons or partnership may have the value of his interest at the date of dissolution ascertained, and shall receive as an ordinary creditor an amount equal to the value of his interest in the dissolved partnership with interest, or, at his option or at the option of his legal representative, in lieu of interest, the profits attributable to the use of his right in the property of the dissolved partnership; provided that the creditors of the dissolved partnership as against the separate creditors, or the representative of the retired or deceased partner, shall have priority on any claim arising under this section, as provided by section 41 (8) of this act.

Section 43. (Accrual of Actions.) The right to an account of his interest shall accrue to any partner, or his legal representative, as against the winding up partners or the surviving partners or the person or partnership continuing the business, at the date of dissolution, in the absence of any agreement to the contrary.

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## Statute

Uniform Partnership Act, 1914